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27 January 1975

MEMORANDUM FOR: Mr. Paul Taylor
Bureau of Economic
and Business Affairs
Department of State

SUBJECT : The Domestic, External and
Regional Impact of Increased
Oil Prices on Developing Nations

Attached is a CIA contribution to papers being
prepared for the oil Consumer/Producer Conference.

It is unclassified.

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Attachment:
as stated.

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28 January 1975

The Domestic, External and Regional Impact
of Increased Oil Prices on Developing Nations

Overview

The developing countries weathered the increased oil prices during 1974 with greater success than anticipated last year.

The adverse impact on domestic economies, so much in evidence in the industrial world, was not felt in most LDCs until later in the year.

- . Almost all LDCs registered some growth in output and real GNP.
- . A 66% rise in import outlays, about half of which reflected higher prices, sustained economic growth but also increased inflation.
- . Tighter money, cutbacks in import growth, higher taxes and price controls became more evident as the year progressed.

The developing countries averted a severe impact on the balance of payments by increasing export earnings by 54%, as higher prices for most LDC exports offset much of the increased cost of oil, food, and fertilizer.

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Capital inflows from a multitude of external sources covered all but at most \$500 million of the 1974 deficit.

The prospects for 1975 are less encouraging. The trade balance will worsen. Prices for oil, food and fertilizer will remain high while those of many LDC exports will fall. Financing the deficit will be more difficult as available resources (IMF credit tranches, reserve drawdowns, and private credits) used in 1974 are increasingly drawn down. The LDCs will be more dependent upon the charity and the policies of the industrial world, OPEC countries, and international financial institutions.

Domestic Impact

Nearly all developing countries achieved positive economic growth rates in 1974. Contrary to earlier expectations overall real growth last year was approximately 4%, or \$16 billion. Population growth offset economic expansion in many countries, but gains in per capita incomes were widespread.

Few LDCs were successful in reducing consumption of imported oil. At best the LDCs were able to reduce the growth of oil consumption through such measures as:

- Higher taxes on oil products to reinforce the effects of higher crude oil prices.

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- . Tax increases on energy related services and goods such as electric rates, appliances, and vehicles, and
- . Allocation systems designed to reduce non-essential or less important oil consumption.

The rate of inflation for the LDCs as a group rose an estimated 30%, largely as a result of higher import prices. The Asian and African developing countries experienced the steepest rises in consumer prices last year. Monetary expansion was rapid in the first six months, but tighter monetary policies were widely introduced in the last half of 1974. Overall, the money supply grew by 27% in the second half of the year after a rise of 35% in the first half, and a 33% rate in 1973.

Increased oil prices and the indirect impact on world inflation and recession, have led to significant changes in economic development priorities. The emphasis now centers upon:

- . Increased agricultural and especially food production,
- . Increased production of chemical fertilizers,
- . Stepped-up exploration for oil and development of alternative energy sources.

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External Impact

The oil importing LDCs are estimated to have paid approximately \$13 billion for petroleum in 1974. The increase from \$4.7 billion the previous year consists of a 170% hike in prices and a 3% increase in volume, as shown below.

LDC Oil Imports

| | <u>1972</u> | <u>1973</u> | <u>1974</u> |
|-----------------------|-------------|-------------|-------------|
| Value (Billions \$) | 3.1 | 4.7 | 13.0 |
| Volume (Billions B/D) | 2.7 | 3.0 | 3.1 |
| Average \$/bbl | \$3.15 | 4.25 | 11.50 |

Indirectly the oil crisis pushed up the cost of the LDC's non oil imports by contributing greatly to higher prices of fertilizer and industrial goods. Total LDC imports ran 66% in the first half of 1974 -- reflecting roughly a one-third increase in prices. LDC export prices also boomed through mid-1974, partly in response to uncertainties generated by the oil embargo, raising export earnings 54% in the first half of 1974. This held the LDC trade deficit to some \$13.6 billion compared with \$6 billion in the first half of 1973 and \$12.8 billion for the year as a whole.

Although only spotty data are available for the second half of 1974, it seems clear that the LDC terms

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of trade deteriorated further as the deepening recession in the developed countries brought down raw material prices while industrial price inflation combined at double digit rates. At the same time growth in the volume of LDC imports slowed greatly. For the year as a whole, the trade deficit of the non-oil LDCs was probably in the order of \$31 billion, of which about \$12.8 billion was with OPEC countries and most of the remainder with OECD countries.

The flow of capital to the developing countries has gained momentum since mid-1974, but it still falls short of the levels needed for balance of payments equilibrium. Credit extensions from international financial institutions and the oil producers increased considerably, although drawings on these credits were small in 1974. (See Table 1.)

In the aggregate, the non-oil developing countries held their international reserves about stable in 1974 (see Table 2), following a 41% jump in 1973 and 48% in 1972.

Regional Impact

The South Asian and African developing countries have been particularly hard hit by the oil price increases. The more diverse and generally stronger economies of

Estimated Capital Flows to Non-OPEC LDC's
1973-74

| | Million US \$ | |
|-------------------------------------|---------------|---------------|
| | <u>1974</u> | <u>1973</u> |
| Total | <u>23,960</u> | <u>21,725</u> |
| Private | <u>6,500</u> | <u>7,500</u> |
| Official Bilateral | <u>11,025</u> | <u>11,300</u> |
| US | 3,325 | 3,300 |
| OPEC | 2,400 | 1,000 |
| Other | 5,300 | 7,000 |
| Multilateral | <u>6,435</u> | <u>2,925</u> |
| IMF Oil Facility | 1,000 | 0 |
| IMF Conventional | 2,700 | 900 |
| OPEC Funds | 200 | 25 |
| UN Special Account | 35 | 0 |
| Other (includes IBRD, IDA, etc.) | 2,500 | 2,000 |

Table 2

Non-OPEC LDC Reserves

| | Billion US \$ | | | |
|---------------|---------------|-------------|-------------|---------------------|
| | <u>1971</u> | <u>1972</u> | <u>1973</u> | <u>1974 (Sept.)</u> |
| High income | 13.0 | 20.9 | 28.9 | 29.7 |
| Middle income | 4.0 | 5.4 | 7.7 | 9.3 |
| Lower income | <u>2.6</u> | <u>2.8</u> | <u>3.8</u> | <u>3.7</u> |
| Total | 20.1 | 29.8 | 42.0 | 43.5 |

Latin America and East Africa have enabled them to confront the impact more successfully, although prospects for 1975 are considerably less favorable.

In South Asia soaring import bills for essential supplies of petroleum, food, and fertilizer have increased trade deficits. The outlook for 1975 is poor.

. India has stabilized its petroleum outlays by imposing a \$1.3 billion ceiling on oil imports for the fiscal year ending 31 March 1975. This will hold petroleum imports at roughly 16 million tons, about the same as last year, but at twice the cost. In spite of concessionary terms from Iran and Iraq, India had to borrow heavily from the IMF to prevent a massive reduction in foreign exchange reserves.

. Pakistan has partly offset its increased petroleum outlays -- from \$57 million in FY 1973 to an estimated \$385 million in FY 1975 -- by aid from OPEC countries. In 1974, Iran provided \$250 million, of a \$580 million loan to be spread over three years. Despite increased aid, Pakistan's balance of payments

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situation remains tight. Large food-grain imports will again be needed in 1975, and markets for its principal exports, cotton and textiles, remains depressed.

. Bangladesh's petroleum imports rose to about one-third of export earnings in 1974. Foreign reserves were virtually depleted by July 1974. Aid commitments of more than \$238 million from Middle Eastern oil producers and the IMF oil facility as well as much larger sums from other donors temporarily eased the situation, but the nation is barely solvent.

. Sri Lanka's oil bill increased from \$25 million in 1973 to about \$95 million in 1974. There is little likelihood of an increase during 1975 since domestic consumption is down 15%-20% from 1973 due to price increases and government restrictions. Projected 1975 export earnings, foreign borrowing and aid inflows fall about \$150 million short of amounts needed to finance already curtailed import schedules and to meet scheduled debt payments.

In 1974, Africa preliminary estimates from a survey of oil importing countries indicate that the trade deficit doubled in 1974. Payments of oil imports tripled, rising from about 8% to 16% of the total imports bill. Price increases for many major African exports prevented a more serious deficit. International foreign grants and loans were the principal means of financing the larger deficits, but much larger amounts will be needed in 1975 as export prices decline. Special arrangements for African oil imports should ease their balance-of-payments problem, although Europe will continue to be the principal source of regional aid. Most Latin American economies maintained their momentum through much of 1974 with the help of high export prices. In recent months, declines in prices of some exports have begun to squeeze some countries, although the picture is mixed. Foreign reserves were down more than \$1.0 billion at the beginning of 1975 and prospects for the year are generally for lower economic growth. Brazil's export outlook is fairly good because of strong sugar and soybean markets. The influx of foreign capital which kept the economy growing at near record levels in the first 6 months of 1974 faltered badly during

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the second half of 1974 and has since only partially revived. Stiff import restraints are now being imposed to prevent further foreign exchange losses and economic growth will almost certainly drop this year, perhaps to half the 10% average of recent years.

. Chile's economy again faces a bleak future after making some recovery from the Allende period. Export earnings promise to decline by more than 50% because of falling copper prices. Capital inflows remain low despite favorable investment legislation and the settlement of outstanding disputes with foreign investors.

. Argentina, on the other hand, should have an easier external position this year. Nearly self-sufficient in oil, Buenos Aires is experiencing little difficulty in financing its import bill despite the high prices it paid for Libyan oil in 1974. High grain prices offset a poor wheat crop and closure of the EC beef market. Although some decline in grain prices is expected, increased wheat

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production and reduced average oil prices should improve Argentina's external economic position.

. Among the smaller oil importers, the sugar and bauxite producers of the Caribbean are faring reasonably well. Elsewhere, however, the small countries of South and Central America generally are confronted with payments problems and some face special difficulties as well. Although the recent agreement for Venezuela to supply petroleum to the five Central American countries and Panama on concessional terms eases their balance of payments problems, their prospects for 1975 remain poor.

East Asian oil importing LDCs experienced sharply slower growth as on average, real growth in 1974 was cut in half. For most countries 1973 was a banner year, and the momentum was sustained until mid-1974 despite higher oil prices. Since then, real growth has slowed sharply largely because of a falloff in foreign demand for goods produced in the region. Despite the downturn, for the region as a whole, foreign exchange reserves

increased by about \$1 billion in 1974. The more advanced economies were particularly hard hit by this decline, while those relying more heavily on agricultural exports fared somewhat better. East Asia's economic slowdown will continue this year principally because only limited recovery is expected in foreign demand for its exports of manufactures and industrial raw materials.

. South Korea, which had an oil-induced increase of \$1.5 billion in its current account deficit last year, faces the most serious problems. Rising unemployment and still serious inflation could worsen the country's already unsettled political situation. Achieving real growth of even 4% will be difficult because Japanese and US demand for Korean manufactures continues weak. Other countries recently have restricted imports of Korean textiles.

. Taiwan had a \$1.5 billion shift from surplus to deficit in its current account in 1974, at least a fourth of which was due to higher oil costs. The slight improvement expected this year will result mainly from weak domestic demand. Taipei has imposed import restrictions,

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principally on consumer goods from Japan.

Various export incentive programs also have been strengthened. The slower pace of exports, however, probably will prevent real growth from rising above the 3% rate of last year.

. Philippines, Thailand, and Malaysia were able to cope with soaring oil costs last year with help from rapid export growth. On balance, growth in these countries is likely to be close to last year's 5%. Food exports probably will continue to do well and domestic demand is being stimulated by increasing public sector spending, but prices and demand for such primary product exports as timber, rubber, tin, and copper will sag throughout most of 1975. The Philippines faces the most serious balance of payments stringencies, and debt-service threatens to emerge again as a problem. Malaysia is least vulnerable to oil-related problems because its oil trade is nearly balanced and exports are expected to increase faster than requirements within the next few years.

Prospects

The developing nations, after successfully surmounting the threat to their energy supplies in 1974, will encounter higher hurdles this year.

- . Increased export earnings to offset higher import costs will have to come more from increased export volume than from price rises and some countries will face a marked worsening in their terms of trade.

Tentative estimates indicate that the LDCs will experience a sharper reduction in growth in 1975. The likely absence of increased export earnings combined with the limited prospects for curtailing imports augurs a current account deficit that could reach \$30 billion.

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